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CURRENCIES AND CREDIT MARKETS

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"It goes without saying that the central bank's missions are (1) stabilizing the value of money; and (2) maintaining and fostering the financial system; in other words, to achieve price stability and financial system stability."

Yasushi Mieno, Governor of the Bank of Japan
Bank of Japan, Quarterly Bulletin, August 1994

HIGHLIGHTS

The final bell is tolling for the Great Financial Bubble. Recent sharp declines in the U.S. stock market suggest the deflation of asset values triggered by 1994's bond-market crash is spreading through the financial markets. We believe the worst is yet to come.

For the Fed, the current situation must seem like a nightmare. What began as little more than a symbolic gesture — a modest tightening to demonstrate its inflation-fighting credentials — has turned into a cascading collapse of asset values. The risk of a meltdown is growing, yet the Fed now is a prisoner of the market's inflationary fears. To switch to an easing stance would only contribute to the growing bearish mood.

In truth, we think inflation is the least of the Fed's worries. Having fueled the biggest frenzy of bond speculation in world history, the Fed faces the aftermath — a vicious circle of unwinding leverage in which falling bond prices lead to still lower bond prices.

As we have repeatedly warned, this downward spiral is only the prelude to a more general liquidity crisis in the United States. While the 1991-94 boom in bonds was driven by rampant debt leveraging, the bull market in stocks was fueled primarily by an unprecedented flight from money assets into mutual funds. But both runs had the same root cause: the Fed's easy money policies. The bond market was the first casualty only because Wall Street's yield-curve playing orgy left it most vulnerable to a rise in short rates. The Fed's initial February rate hike instantly disrupted the flow of funds into the market, triggering the worst bond bear market since the Great Depression.

Given the bond disaster, stock markets — both in the United States and around the world — have proven surprisingly resilient, even though the strong Dow has masked stiff losses in the broader market. Still, optimism about the economy and the outlook for corporate earnings have sustained inflows, especially from U.S. stock mutual funds.

But the stock market's hour may have come. Higher short-term yields, like the virtually risk-free 7.2% now available on a two-year Treasury note, are compelling competition for a market that appears dead in the water. By now, surely many investors have noticed that virtually every investment made this year in stocks or bonds is well under water. Cash, once trash, now is king.

How serious is the crisis? Will the slide in stock market prices turn into a real crash, similar to the 1990 bursting of Japan's asset bubble? To us, this is the overriding issue.

A CRASH IN THE MAKING

In our last letter, we posed and answered the question: How does one identify the creation of a bubble, or asset price inflation? This month, we ask and answer a related question: What are the tell-tale signs of a bursting bubble, or asset price deflation?

Here we think it is crucial to distinguish between the impact of rising short-term rates on the financial markets, and their effects on the real economy. Most analysts focus on the latter, assuming the real economy drives the markets, not the other way around. Currently, Wall Street is fixated on the question of whether the U.S. economy will slow towards its potential growth rate of 2.5%. This is believed to hold the key to the perceived inflation threat, and thus to the direction of rates and markets.

As our readers know, we take a different approach. In our view, inflated financial markets are the U.S. economy's true vulnerable spot, and asset deflation the major risk facing both the United States and the world. As we look around, we see ample signs the Fed has set the deflationary spiral in motion. Ultimately, plunging asset markets will crush the current U.S. expansion, endangering the still-fragile global economic recovery as well.

Actually, changes in monetary conditions always are felt first in the capital markets. Rate hikes influence the real economy indirectly by curbing the demand for credit to spend on goods and services. This takes time. But they impact the financial markets directly by raising the desire to hold money in lieu of securities. This shift in liquidity preference can be immediate and dramatic — as the Fed found out after its first rate hike in February.

Given the unexpected strength of the U.S. consumer borrowing binge, it may well be doubted whether the current 5.5% federal funds rate is high enough to quickly break the economy's momentum. Personally, we think this recovery already is petering out. But even if we are wrong, so much the worse for the financial markets: They would then face the unhappy prospect of even more Fed rate hikes to come.

In any case, the question is largely irrelevant. There is no doubt in our mind that rates already have moved high enough to pound the financial markets. The shift back into cash, which began in February, is spreading and accelerating. We think panic sellling and a general market collapse are only a matter of time.

As we noted in our last letter, we are struck by the parallels between the Japanese bubble of the late 1980s and the Greenspan bubble of the early 1990s. Like the Fed, the Bank of Japan believed it was acting cautiously when it nudged its discount rate from 2.5% to 6% over a 15-month period in 1988 and 89. But this gradual tightening ended in disaster for both the financial markets and the economy.

Does the Fed have a better chance to engineer a soft landing? We doubt it. For starters, the Fed is in a far more precarious position than the BOJ, due to the huge difference in the balance of payments between the two countries.

Given Japan's enormous external surplus and strong yen, the BOJ always has had a free hand to set interest rates according to domestic requirements. If anything, the BOJ can be faulted for failing to recognize quickly enough the need to drop rates to extremely low levels to counteract the collapse of the bubble. But once it started, the bank did cut rates significantly. The official discount rate has been at just 1.75% since September 1993. Call money and CD rates hover around 2% or lower.

The Fed doesn't have the same luxury. The pricking of the Greenspan bubble has badly undermined the dollar, already weakened by America's chronic current account deficits. If the Fed were to shift back now to a policy of monetary ease, the dollar could well collapse, sending market rates shooting even higher, and exacerbating the liquidity squeeze.

Global Capital Market Trends

Equities
Selected Markets, % Change

Country (November 30)	Month	YTD	Y-Y	Vs. 12-Mos Hi	Vs. 12-Mos Lo
Australia	-7.5%	-13.0%	-5.9%	-19.2%	1.8%
Canada	-4.6%	-5.3%	-2.1%	-11.2%	3.4%
France	3.7%	-12.9%	-6.4%	-16.1%	8.3%
Germany	1.1%	-9.6%	-0.5%	-9.8%	4.5%
Hong Kong	-12.2%	-28.8%	-7.2%	-30.6%	1.2%
Japan	-4.6%	9.5%	16.3%	-11.5%	16.3%
Mexico	1.5%	-0.4%	17.0%	-10.1%	32.4%
Spain	2.9%	-9.1%	0.2%	-17.4%	6.2%
U.K.	-0.5%	-9.9%	-2.7%	-12.5%	7.1%
U.S.	-4.0%	-2.7%	-1.8%	-5.9%	3.4%

Ten-Year Bond Yields
Selected Markets, Basis Point Change

Country (November 30)	Current Rate (%)	Month	YTD	Y-Y	Vs. 12-Mos Hi	Vs. 12-Mos Lo
Australia	10.47	-4	380	366	-24	410
Canada	9.17	7	254	229	-27	282
France	7.90	-42	226	185	-54	228
Germany	7.32	-31	179	144	-44	179
Japan	4.71	-12	140	123	-24	146
Spain	11.11	-13	310	255	-33	341
U.K.	8.45	-28	235	184	-58	236
U.S.	7.91	10	211	208	-13	234

Exchange Rates
Versus U.S. Dollar, % Change

Country (November 30)	Current Rate	Month	YTD	Y-Y	Vs. 12-Mos. Hi	Vs. 12-Mos Lo
Australia ($)	1.31	3.0%	10.9%	13.9%	0.0%	13.8%
Canada ($)	1.38	-1.7%	-3.5%	-2.7%	-5.0%	1.5%
France (FF)	5.38	-4.6%	9.1%	9.2%	-5.5%	10.0%
Germany (DM)	1.57	-4.4%	9.8%	8.6%	-5.2%	11.1%
Japan (Yen)	99.0	-2.1%	11.5%	9.3%	-2.5%	12.5%
Spain (Pta)	130.9	-4.6%	8.6%	7.0%	-5.6%	10.0%
U.K. (Sterling)	1.57	-4.3%	6.0%	5.3%	-4.5%	7.0%

ON BORROWED TIME

Like others, we admit we've underestimated the resilience of the U.S. economy. Growth has continued despite the collapse since February of the 1992-93 boom in mortgage refinancing, which freed up billions of dollars in cash for consumers to spend on cars and other durable goods. This strength reflects three factors:

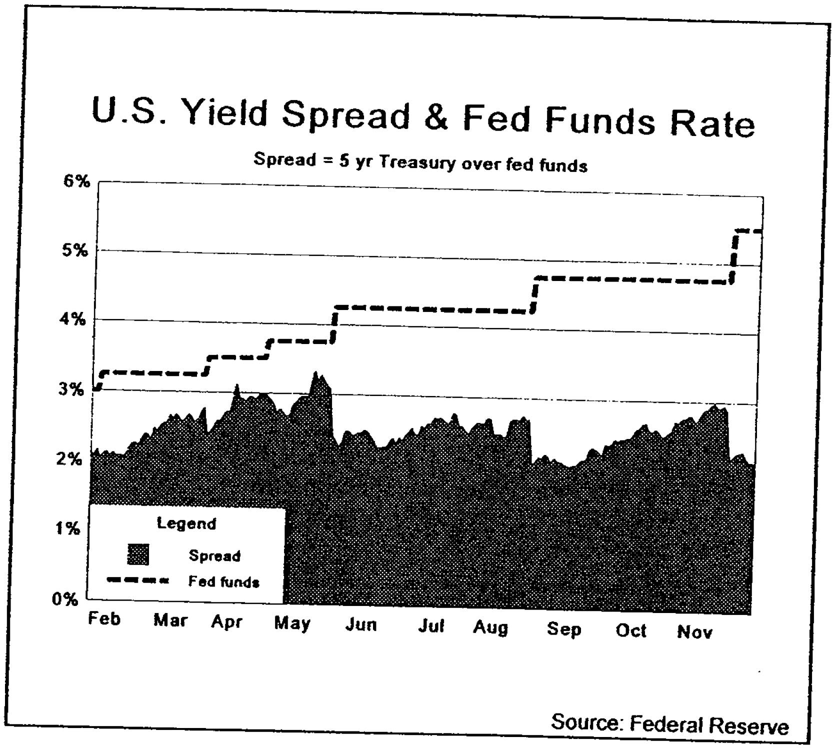
- Consumers are demonstrating an astonishing willingness to use credit cards and other forms of installment debt to sustain spending. Having locked in low-rate mortgages last year, many homeowners apparently feel they have room to leverage up their finances.

- A stubbornly steep yield curve allows borrowers to substitute relatively cheap short-term debt for expensive long-term debt. Many U.S. home buyers, for example, have switched to adjustable rate loans as rates on 30-year fixed mortgages have soared.

- Business inventories have mounted as final demand has slowed. This normally is the precursor of a pending recession. Some analysts argue the present accumulation is desired, and so is not a sign of economic weakness. This misses the point. The issue is not whether firms are intentionally stockpiling goods, it's whether final demand will remain strong enough to absorb that backlog. We think it will not.

That the U.S. economy should continue to grow in the face of sharply higher interest rates really isn't that unusual. In light of the Fed's super-easy monetary policy of 1991-93, it's no surprise the economy would continue to benefit from the lagged effects.

Again, the parallel with Japan's bubble is obvious. Japanese GDP growth, private consumption and business investment all posted strong gains in 1990 and 1991, even as stock and real estate prices crumbled. It wasn't until 1992 — more than two years after the initial crash — that the economy finally tumbled into a deep recession.



We doubt the United States will see such a lengthy reprieve. The U.S. economy is riddled with structural weaknesses, and the current recovery already is in its advanced stages. The collapse of the Greenspan bubble, we think, will inevitably translate into another slump.

The size of that bubble, and its fragility, can best be seen in the vehemence with which the bond markets reacted to the Fed's initial modest rate hikes. It is perfectly normal for long rates to rise when short rates go up. But the increase usually isn't proportional — that is, the rise in long rates is smaller than the rise in short rates. Past Fed tightenings, therefore, almost always resulted in a flatter yield curve. Indeed, in most past cycles, short rates eventually moved above long rates, inverting the curve.

We mention this familiar pattern only because it highlights the complete absurdity of Wall Street's expectations at the start of the year. The hope was that a preemptive strike by the Fed would dampen inflation fears, sparking a bond market rally. It is ironic that long rates not only flouted conventional wisdom, but rose even more than the Fed's initial, timid moves.

But as the chart above shows, the Fed's six rate hikes so far this year have had little lasting effect on the slope of the curve. This has been particularly true in the short and intermediate ranges, where the speculative frenzy was most intense. For example, the spread between the federal funds rate, which is pegged by the Fed, and the yield on the five-year Treasury note stood at 157 basis points on October 15 of last year, when rates hit their low for this cycle. By Feb. 3, the day before the first Fed hike, it had widened to 210 basis points. As the bond market crumbled last spring, the spread shot as high as 333 basis points. Today, it's just over 200 basis points, about where it stood on Feb. 3.

While each Fed tightening has resulted in a temporary flattening of the curve, within days or weeks the spread has bounced back to its former size — or moved even higher. It remains to be seen whether the Fed's latest rate increase will leave a more lasting impression.

Nothing like this has happened since the early 1930s. Then, in the face of raging price deflation and a decline in short rates to barely 1%, the bond market still slumped, pushing yields higher. The reason: desperate banks sold bonds to cover losses on defaulting loans and meet cash withdrawal demands from depositors. While the current situation may seem far removed from the depths of the Great Depression, there are some ominous similarities, as we shall explain.

What has driven global bond yields up so dramatically? As we have repeatedly explained: It isn't inflation. It's speculation, highly leveraged global bond speculation — the wildest the world has ever seen.

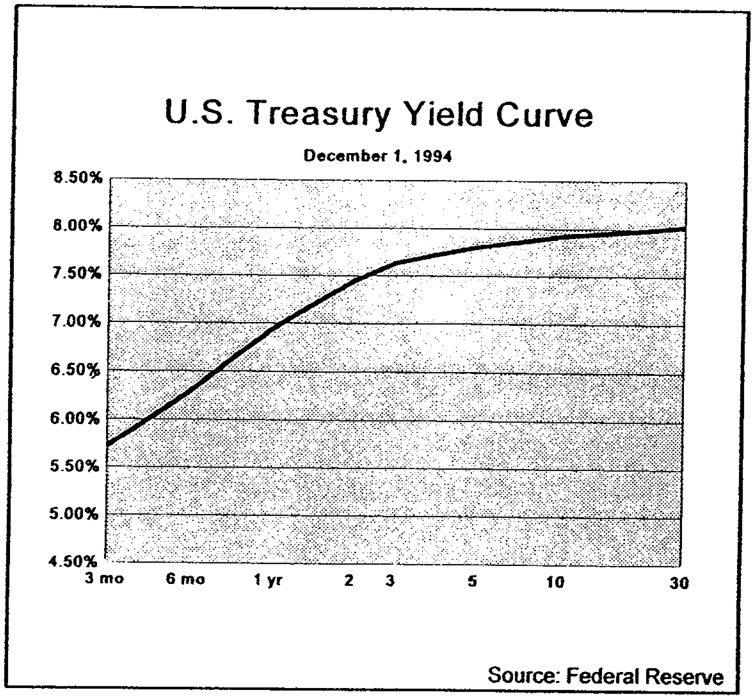
The late financial boom was a bubble of unprecedented magnitude, and now it is bursting. Thousands, if not hundreds of thousands of overleveraged speculators are caught in a cruel trap. Liquidating their bond portfolios would force huge capital losses. But holding on in hopes of a rally carries its own costs. The

rise in short rates has left them with a negative carry — that is, their interest costs now exceed their interest earnings. With each passing month, they're slowly bleeding to death.

Many hedge funds and other institutional money managers have had no choice but to sell, to meet the demands of creditors or investors who no longer have the stomach for such huge losses. This is what has driven interest rates up across the board, leaving the Fed to play reluctant catch up.

What lies behind this unusual steepness in the yield curve? The most obvious explanation is that the pegged federal funds rate remains out of whack with market forces. More to the point, it suggests the Fed, despite its six hikes, continues to hold the fed funds rate at an artificially low level.

The persistent steepness of the curve is an almost irresistible temptation to the surviving yield-curve players to try their luck again, in hopes the Fed is near the end of its tightening program. But the speculators aren't reaching as far up the curve as they did during the bubble's glory days.



Source: Federal Reserve

The long end, meanwhile, is benefiting a bit from Treasury's decision last year to trim the sale of 10- and 30-year maturities, as well as from speculative bottom fishing by players betting that the traditional flattening of the curve eventually will assert itself. The result is a oddly shaped yield curve, one featuring a sharp right angle at about the 3-year maturity.

Our main point here is to highlight the powerful deflationary forces holding the yield curve at such a steep slope. While yields at the short-end have reached levels attractive enough to lure some small investors out of the stock market, these purchases still are more than offset by the steady unwinding of leveraged positions. At the same time, though, conventional wisdom still holds that sooner or later the economy will slow, the Fed will reach the top of the rate cycle, and the big bond rally will begin. So each tightening move triggers a modest rebound in sentiment, as hopes rise that the end of the tunnel is in sight.

But the rate cycle has turned perverse. Unable or unwilling to see the collapse of the bubble it helped create, Wall Street clings to the false notion that the bond crash is entirely due to escalating fears of inflation. Under the circumstances, it's perhaps not too surprising that those most damaged by the Fed's moves — Wall Street's leveraged yield curve players — would scream the loudest for an even tighter monetary stance. Yet each move only gives the liquidity squeeze another turn, forcing yet another group of overleveraged players to capitulate.

For us, it all boils down to two questions:

- How big is the backlog of leveraged bond positions that are locked into losses, and which h to be liquidated?

- What are the potential future flows of funds into the U.S financial markets?

We don't pretend we have all answers to these questions. The necessary statistics simply aren't available. But anecdotal evidence permits some reasonable guesses. It tells us, for example, that the cumulative damage suffered by U.S. banks in the bond market so far this year is equal to nearly half of their entire write offs from the real estate collapse of the 1980s and early 1990s.

THE FED'S FATAL MISTAKE

Fed chairman Alan Greenspan is widely praised for rescuing the banks from that debacle by dropping short-term rates to rock-bottom levels. This slashed interest payments to bank depositors to $79.4 billion in 1993, down from $151 billion in 1990.

But what Greenspan and company really did was to drive out a demon by calling in the chief devil, Beelzebub. Trying to stabilize the banks, they destabilized the entire financial system.

The big, new financial maladjustments are in the huge debt-leveraged bond positions that result from the yield-curve playing binge, as well as in the strained balance sheets of the consumers who fled out of low-yielding money assets into illiquid bond and equity mutual fund shares, and embarked in addition on a new borrowing binge.

Taking stock of all the effects resulting from the Fed's interest-rate policies, obviously the biggest effect consisted in a massive income redistribution from American savers to borrowers. As to the banks, their gross interest-rate expenses plunged. Indeed, from 1990 to 1993, these costs dropped from $161.3 billion to $79.4 billion, or by $81.9 billion. Bank depositors lost half of their income. But it's a great mistake to think that this was the main source of the banks' increased profits during that period.

Very little of it was. The banks' gross interest income plummeted at the same time from $320 billion to $244.6 billion, or by $75.4 billion. Their record-high profits resulted rather from soaring non-interest income and diminished provisions for bad loans.

After all, the banks' total net income surged from $15.7 billion in 1990 to a record $43.3 billion in 1993. But as they drastically hiked their dividends, their net gains in the form of retained income really were quite modest, amounting over the four years 1990-93 to about $42 billion.

Of course, there was a hazardous flip side to the Fed's super-easy monetary stance. Trying to profit as much as possible from the steep yield curve created by the Fed, the banks stampeded into bonds, raising their holdings from $587 billion in 1990 to $979 billion in July 1993. The big question, then, is how large are the potential losses on those holdings.

Fed call reports for the first half of 1994 show the banks sitting on unrealized capital losses of $14.5 billion on their bonds and other fixed-income securities, down from capital gains of nearly $12 billion at the end of last year. In other words, the bond crash has wiped out nearly $27 billion in paper asset values since the first of the year. The bond market's continued slump since the second quarter surely has added to those losses, probably pushing them above the $30 billion mark. By way of comparison, real-estate related losses booked by U.S. commercial banks totaled $33.3 billion in the years 1986 through 1992, according to the Federal Deposit Insurance Corporation.

One casualty of the bond crash has been the movement to introduce some degree of honesty into bank bookkeeping. Last year, the accounting profession's rule-making body, the Financial Standards Accounting Board, released new rules which had the effect of forcing banks and other financial institutions to mark the bulk of their bond holdings to market when calculating their regulatory capital requirements.

U.S. banking regulators were staunch advocates of this change — until the crash. Last month, they abruptly dropped the mark-to-market rule. Ironically, this actually may be a modest plus for the bond

market, because it reduces the risk of forced sales by banks looking to dress up their balance sheets before the end of the year.

Our conclusion is that banks still face far greater problems with their bond portfolios than they ever did with their previous bad loan problems. This could seriously impair their future ability to create liquidity through lending and new investments. Certainly, any further rises in long-term interest rates and associated capital losses would spell disaster.

BROKERS ON THE BRINK?

We've also looked at the published balance sheets of various broker firms and found precisely what we suspected — simply staggering amounts of leverage in bonds. As of June 30, 1994, we totaled the following bond portfolios, all of them, of course, financed with cheap short-term money: Merrill Lynch, $125 billion; Salomon Brothers, $159 billion; Kidder Peabody, $104 billion; Bear Stearns, $40 billion; Paine Webber, $30 billion; Lehman Brothers, $101 billion; Morgan Stanley, $78 billion. These positions have to be viewed in light of equity capital ratios of just 2-3% of total assets.

All these figures relate to June-July 1994. In all cases, bond holdings were considerably higher than they were at year-end 1993. This implies that these positions, far from being unwound, actually were built up further during the first half of 1994.

Considering the narrow equity ratios and the double whammy these firms have suffered this year — savage capital losses on their bonds, coupled with the higher short-term borrowing costs imposed by the Fed — we have to wonder if there are any brokers left on Wall Street who would have a bit of equity capital left if they honestly marked their portfolios to market.

What we don't know is the extent to which brokers hedged their highly-leveraged positions. Our guess is that they didn't. Believing their own propaganda, most were far too bullish to see any downside risk. To the contrary, most probably had long exposures in the futures pits and other derivatives markets, adding to their losses. In any case, to fully hedge an outright speculative long position would be nonsensical — it would only deprive the speculator of any profit from his wager.

For this reason, it has always amused us to read or hear that the derivatives and futures markets serve to hedge risks. What they really do is to permit the construction of ever more highly leveraged pyramids of speculation. The real benefit of derivatives is that they don't show up on the balance sheet — allowing many a financial gambler to conceal his reckless bets.

The best examples of this can be found in corporate America, where any number of firms were able to embellish business profits as long as interest rates fell. Some saw the approaching market turn and stepped aside. Others foolishly stayed long and suffered the consequences.

In the wake of this year's bond crash, many corporate leaders have engaged in a bit of historical revisionism, insisting their derivatives transactions constituted nothing more than an attempt at "risk management" or "interest rate hedging." The big losers have pointed accusing fingers at their bankers, claiming they were misled into a life of rampant speculation. The absurd image of Fortune 500 corporations posing as innocent babes in the world of finance needs little additional comment from us. It merely illustrates the sheer insanity of the bubble, and the intensity of the crash.

While derivative markets were the great success story of the boom, we wonder how they will function in a prolonged bear market. It has always been our view that the trading of derivatives and futures makes bull markets more bullish and bear markets more bearish. This arises from the fact that in order to avoid losses on their derivatives dealings, banks and other market makers must create positions on the cash

assets underlying the contracts they have written. These are called delta, or neutral, hedges. In this way, the cash markets are forced to absorb the brunt of the leverage created in the derivatives markets.

The most famous example of this fact came during the October 1987 stock-market crash. Prior to the crash, any number of speculators convinced themselves they could easily and cheaply protect themselves from a market downturn by purchasing "portfolio insurance" — that, is by selling stock-index futures against their actual share holdings. Any losses in the cash market could be offset by profits from the sale of the futures. Because the futures pits allowed the use of far greater leverage than the cash markets, the costs of the hedge were less than the gains that could be earned in a rising stock market.

That was the theory. But when everyone wants to hedge in the same direction, such devices quickly boomerang. In practice, portfolio insurance was an unmitigated disaster.

During the 1987 crash, waves of one-sided futures selling by portfolio insurers overwhelmed the market, pushing S&P 500 futures far below cash prices in New York. According to the portfolio-insurance concept, this should have led program traders to jump in and buy the cheap futures, pushing prices back towards the cash market. But just the opposite happened: Arbitragers, hoping to make a quick turn, bought the futures all right, but they also sold shares into the declining cash market. This put additional downward pressure on stock prices, triggering a new round of futures selling in Chicago. The result, of course, was a meltdown.

Something very similar happened this year in the $1.4 trillion market for mortgage-backed obligations, or MBOs. In a rising interest-rate environment, both the average maturity and the duration of MBOs lengthen dramatically as more homeowners elect not to refinance their existing mortgages. To hedge against this risk, securities dealers and other big MBO speculators take large short positions in Treasuries of comparable duration. In a market slump, profits on the short sales are supposed to offset losses on the MBOs.

The problem: As rates rose this year and MBO durations extended, speculators were forced to move their short positions further and further out the Treasury yield curve to maintain their hedges. But this tidal wave of short selling drove long-term rates still higher, steepening the curve. MBO maturities and durations soared, triggering still more short selling in the Treasury market. As in 1987, a strategy designed to insure against loss actually gave rise to even bigger losses.

LIQUIDITY IS THE KEY

This brings us back to the key issue and the main danger: The unfolding liquidity crunch. This is scarcely a new topic for us. We have long regarded the U.S. liquidity riddle as the critical factor in our analysis of both the financial markets and the real economy.

Our long-standing conclusion: The tremendous growth in credit and debt in 1991-93, despite the absence of broad money growth, was the crucial, tell-tale sign of the Greenspan Bubble. By vastly increasing the recycling of existing bank deposits (or, in technical terms, by fostering an explosion in monetary velocity) the bubble created the illusion of boundless liquidity in U.S. and global financial markets.

Another casualty of the U.S. bubble economy of the 1990s was the balance sheet of the American consumer. Faced with super-low short-term interest rates, consumers embarked on two binges: A run into short-term debt to finance spending, and an unprecedented run out of money assets and into securities in order to improve yields. In other words, they switched massively from liquid into illiquid assets.

The net result: Total security holdings of U.S. households skyrocketed in market value from $3.5 trillion in 1990 to $5.26 trillion in mid-1994, while holdings of currency, bank deposits and money-market mutual

fund shares dropped from $3.35 trillion to $3.25 trillion. Household indebtedness, meanwhile, jumped by more than $800 billion, to $6.1 trillion during that same period.

U.S. Money Stock Measures

Percent change at seasonally adjusted annual rates

Period	M1	M2	M3
3 Months from July to Oct. 1994	1.6%	-1.1%	1.0%
6 Months from April to Oct. 1994	1.3%	0.1%	1.5%
12 Months from Oct. 1993 to Oct. 1994	3.2%	1.3%	1.3%

Source: Federal Reserve

The piercing of the bubble has permanently altered that happy scene. The flight back to cash by millions of investors and savers is shrinking the supply of investable and loanable funds. Velocity is collapsing. The extreme liquidity drought long implied by the stagnant broad money aggregates suddenly has become a tangible reality.

Our extremely negative view of U.S. liquidity trends is based on four observations:

- Money growth is growing ever weaker, and is on the verge of contracting, as the table above shows. Nothing like this has happened since the 1930s.

- Overall liquidity, as measured by the ratio of money to the flow of income and spending, shows a sharp downtrend since 1990. During this period, 20% growth in nominal GDP was matched with record-low 2.5% growth in broad money. The whole of this meager monetary expansion stemmed from an increase in currency in circulation, most which flowed into the global black markets, where U.S. dollars are the main currency.

- Private household liquidity, as measured by the ratio of money assets to total assets, has dropped to its lowest level in more than 30 years.

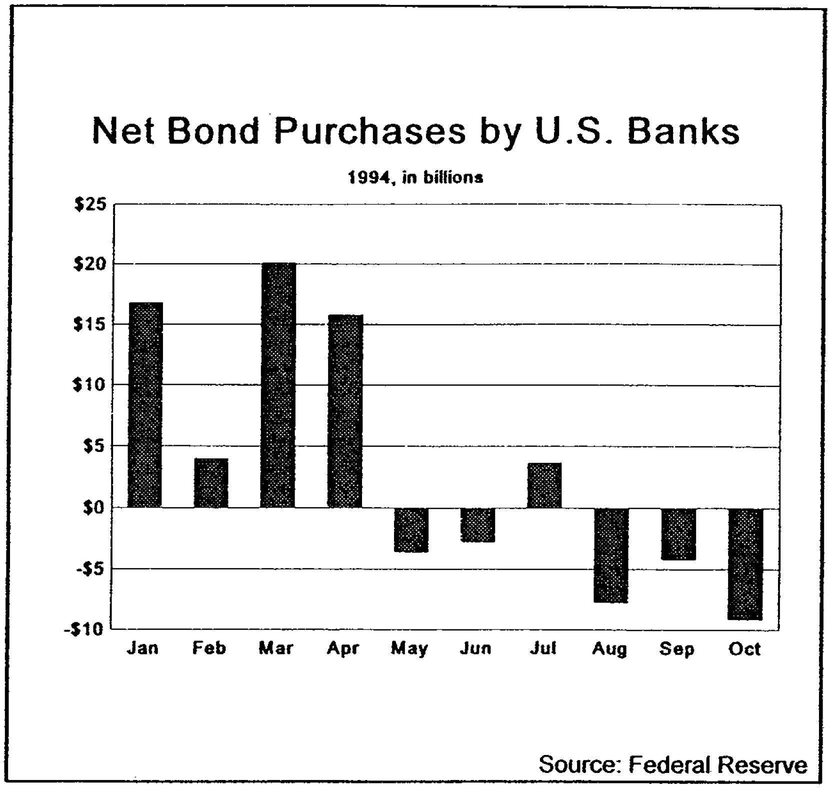
- Money growth has become so extremely weak because deposit creation by the U.S. banks has completely stopped. Even borrowing in the Euromarkets, their previous main funding source, has stopped growing. Instead, banks are running down their bond portfolios to raise funds for their lending operations. Sooner or later, we may well see outright money contraction.

WHAT MAKES A CRASH?

This total breakdown of deposit and money creation is really the most ominous development in the U.S. monetary picture. Every crash has one and the same cause: A general rush for liquidity — to get out of other assets and into bank deposits and other liquid money assets.

More precisely, crashes occur when businesses and individuals begin to feel overextended, and seek to rebuild cash balances by selling illiquid assets. But this is self-defeating for the community as a whole because for every seller who in this way increases his money holdings, there must be a buyer who decreases his own. The net effect is that total available liquidity — the money stock — remains unchanged. The only result of the scramble back into cash is the collapse of asset prices: the famous bursting of the bubble.

The worst recessions and depressions in history have been associated with crashes in asset markets resulting from the bursting of speculative bubbles. And at the root of every one of these crashes was a dramatic implosion in market liquidity leading to panic selling.



The most famous of these disasters, of course, was the U.S. stock market crash of 1929, and the savage deflation of 1929-33 that followed. The most recent example is the collapse of the Japanese financial bubble, deliberately pricked by Bank of Japan in 1989. The resulting 60% drop in stock prices and up to 70% decline in property values triggered Japan's longest and worst recession since World War II.

Now a similar downward spiral is spreading throughout the U.S. stock and bond markets, and threatening the precarious stability of the entire financial system.

To contain the vicious, self-defeating circle of rising U.S. demand for money and collapsing asset prices essentially requires a rising supply of money — in other words, an increase in bank deposits. Who can deliver bank deposits? Banks alone, either by lending or through bond purchases. If the public wants to become more liquid, only the banking system can permit it to do so.

THE UNFOLDING LIQUIDITY CRUNCH

While the U.S. economy currently may look relatively strong, the financial structure under it is rotten and getting rottener. Overall liquidity, as we have explained, is by any measure in an alarming downtrend. At the same time, the slumping financial markets signal that the demand for liquidity is sharply rising, while liquidity growth — as reflected in the money data — is at its worst in the whole postwar period. If this trend continues, a Japanese-style crash is inevitable.

Since banks account for the bulk of money or liquidity creation, the pivotal question at this point is: Can the U.S. banks be expected to boost liquidity any time soon?

The normal way for banks to inject liquidity in the face of asset deflation would be to embark on large-scale bond purchases. This would support the asset markets directly and entail a corresponding increase in bank deposits — in the money supply. But we do not think the U.S. banks are up to this task. The main obstacle: their existing, out-sized bond holdings.

In truth, the walls are closing in — for the banks, the markets and, not least, for the Fed. Even the much-hoped for slowdown in the economy cannot save the day. As in post-bubble Japan, a slumping economy will only intensify the scramble for liquidity. The nightmare scenario of high or rising interest

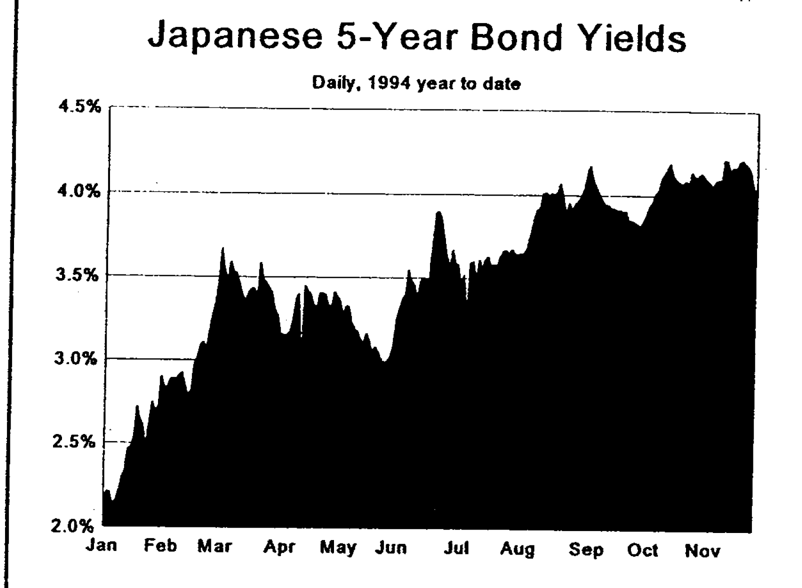
rates at a time of economic weakness, which the United States flirted with during the 1990-91 recession, will return with a vengeance.

It would be up to the Fed, then, to try to reflate the bubble with another dose of super-low rates. But in the aftermath of this year's bond crash, it is a pipe dream to think the Fed can simply restart the bond market's engines by dropping rates back to their former ridiculously low levels.

THE LESSON OF JAPAN

The Japanese experience proves how futile such an effort can be. While the BOJ has dropped short rates to rock-bottom levels, Japanese banks remain immobilized. New lending is virtually nonexistent. To raise funds to cover write downs on existing bad loans, many banks have started taking profits on bonds and long-held stocks. As a result, yields on Japanese government bonds have soared this year, despite the deeply depressed economy.

That Japanese money growth has not completely halted is due solely to the BOJ's continuing efforts to prop up the sinking U.S. dollar. The bank reportedly is purchasing something on the order of $1.5 billion a week, and has been for most of this year. Assuming an average exchange rate of 103 yen, this injected roughly 6.6 trillion yen into the Japanese banking system in the first 10 months of this year. Yet during that period of time, Japanese M2+CDs rose by only 4.4 trillion yen. In effect, the BOJ has been pumping out yen at a prodigious rate — and still it hasn't managed to offset fully the contraction in domestic liquidity.



Source: Bank of Japan

To make matters worse for the Fed, one of main legacies of the Greenspan bubble is the explosion in the supply of dollars — or more accurately, of Eurodollar deposits — held by foreigners. An economic slump surely would accelerate the run on the dollar, adding to the financial markets' woes. We think the climatic events will arrive some time next year, when a weakening U.S. economy triggers widespread cries for monetary easing, while a falling dollar demands just the opposite course. Woe then to the Fed, and woe to any investor foolish enough to linger in the U.S. stock and bond markets.

CONCLUSION

Don't be fooled by the recent strength of the U.S. economic data. With the consumer borrowing binge and the inventory boom, the recovery is living on borrowed time.

Will it be a "soft" or a "hard" landing? That's the question. Our view: In light of the overleveraged conditions of the U.S. financial structure, a hard landing is a virtual certainty. But this glaring weakness of the system is in general conveniently ignored.

The consensus is that the markets have been driven down by exaggerated bearishness. This is widely considered to be bullish for the markets. What we see is nothing but disguised bullishness.

Both the bulls and the so-called bears are looking for a final, happy landing with easier money, rallying bonds and stocks on a slowdown of the economy to prolonged non-inflationary growth of supposedly 2.5%. The only difference between them is that the primary bears expect further monetary tightening and in the interim therefore sharper corrections in the markets, before the soft landing is to take place.

What about the dollar? Its recent gains are based on the perception of an overheating U.S. economy that requires more Fed tightening. Even if this happens, the dollar's rally is very limited in time and extent. Window dressing by dollar bulls for year-end also plays some role.

With the slumping U.S. financial markets, the large capital inflows that are necessary to sustain a dollar rally can't materialize. Once the economy's slump comes into view, the real dollar crisis will begin.

Bear in mind: a liquidity crunch and a savage asset deflation are in the making in the United States. It's high time to shift into liquid assets. Our particular preferences remain cash and the shorter-term bonds of the hard-currency countries — Germany, Switzerland, Austria and the Netherlands.

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